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## **IADI TO ADOPT THE KEY CONCLUSIONS OF THE APEC POLICY DIALOGUE ON DEPOSIT INSURANCE AS OFFICIAL IADI GUIDANCE**

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### **1. Purpose**

At its ninth meeting in Basel in June 2005, IADI's Executive Council decided to adopt as official IADI guidance the key policy conclusions arising from the February 2004 APEC Policy Dialogue on Deposit Insurance.

The following paper provides background material on the APEC Policy Dialogue and sets out the key policy conclusions from the Dialogue which were adopted as official IADI guidance for developing and enhancing effective deposit insurance systems.

### **2. Background**

Under the auspices of the APEC Finance Ministers' process, the APEC Policy Dialogue on Deposit Insurance was held in Kuala Lumpur, Malaysia from February 16 to 18, 2004. It supported APEC's ongoing efforts to promote greater understanding of the policies needed to strengthen financial systems in the APEC region. The Dialogue provided an opportunity for participants to meet and share information and experiences on building effective deposit insurance systems. It was comprised of presentations from invited international experts and practitioners and open discussion on selected policy issues.

The Dialogue was chaired by the Canada Deposit Insurance Corporation (CDIC) and hosted by Bank Negara Malaysia. It was attended by representatives from 16 of the 21 APEC economies as well as a number of non-APEC economies. Most attendees were senior policy makers and representatives of deposit insurers, supervisory authorities, finance ministries and central banks. Participants from the International Association of Deposit Insurers, International Monetary Fund, the World Bank, academics and private business firms were also in attendance.

The three main issues addressed by the Dialogue were:

1. Legal protection and indemnification for individuals working for deposit insurers and other financial system safety-net participants<sup>1</sup> – including, oaths of office, conflict of interest codes and confidentiality provisions;
2. Governance and interrelationship management among financial safety-net participants; and
3. Trigger mechanisms for prompt corrective action when dealing with troubled deposit taking institutions (i.e. hereafter referred to as banks).

The Policy conclusions from the Dialogue are set out in section 3 of this paper and were presented at the APEC Finance Ministers' Meeting in Santiago, Chile in September 2004.

### **3. Key Policy Conclusions**

The key policy conclusions arising from discussions at the Dialogue were:

#### **i) Legal protection and indemnification issues**

- Situations exist in a number of economies where individuals (e.g. current and former employees, directors, officers and agents) working for deposit insurers and other organizations involved in the financial system safety net are held personally liable for their decisions, actions or omissions taken in good faith in the normal discharge of their legal responsibilities.
- While this lack of legal protection may have been established to help improve accountability, it reduces incentives for these individuals to be diligent in the carrying out of their mandates. This can result in costly delays when dealing with troubled banks and resolving failed banks. Ultimately, the lack of legal protection can result in a serious erosion of credibility, independence and integrity of the deposit insurer and other safety net participants.
- Thus, individuals working for deposit insurers and other safety net participants should be protected against civil and criminal liability, except in cases of misconduct, for their decisions, actions or omissions taken in "good faith" while discharging their mandates. Legal protection should be

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<sup>1</sup> A financial system safety net usually includes the functions of prudential regulation and supervision, lender of last resort facilities and some form of deposit insurance.

codified in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.

- However, legal protection must coexist in an environment where there is clear accountability. This means that while individuals should be legally protected, they must be required to follow appropriate oaths of office, conflict of interest rules and codes of conduct to ensure they remain accountable. And, it is important that the safety net organization itself should remain accountable for its conduct. Provisions regarding secrecy and confidentiality concerning all documents, information and records pertaining to matters dealt with by the deposit insurance entity also need to be in place.

## **ii) Governance and interrelationship management among financial safety net participants**

- The sound governance of organizations comprising the safety net strengthens the financial system's architecture and contributes directly to system stability. The four major elements comprising sound governance of organizations are: independence, accountability, transparency and integrity. All are equally important and reinforce each other in supporting good governance practices.
- The view that operationally independent and accountable safety net organizations, with clear mandates and which are insulated from undue political and industry influence, provide greater integrity, credibility and legitimacy than entities lacking such independence is embodied in the standards that are assessed in the World Bank-IMF Financial Sector Assessment Program (FSAP).
- Experience also shows that a separate, operationally independent and accountable deposit insurance entity working within the financial safety net is the "best practice" model available to provide: (1) the most effective incentives for the control of moral hazard affecting a deposit insurer; (2) the greatest protection of the interests of depositors; (3) more balanced and effective decision-making; and (4) promotes more extensive monitoring of potential conflicts than entities lacking such independence.
- Information sharing among all safety-net participants is essential. Such information should be timely, accurate and relevant with due respect given to maintaining confidentiality when required. Formal information sharing arrangements either through legislation, memoranda of

understanding, legal agreements or a combination of these techniques are necessary.

- The most important and effective way to promote smooth coordination on the part of financial safety net participants is to provide for clear mandates and the division of powers and responsibilities among them. Formal arrangements are also necessary in providing a general framework for safety net participants to coordinate their related activities.

**iii) Trigger mechanisms for prompt corrective action when dealing with troubled banks**

- In a competitive financial system banks can and do fail. Ensuring that a framework exists for prompt corrective action and resolution of troubled banks can reduce the costs to depositors and the deposit insurer, contribute to financial system stability and help reduce the likelihood of an isolated bank failure turning into a financial crisis.
- Institutional arrangements for prompt corrective action need to ensure that the safety net participants involved have clearly defined mandates, roles and responsibilities, that the prompt corrective action framework is well defined, transparent and well understood and that there are sound information sharing and coordination arrangements among the safety net organizations. In addition, these arrangements need to be supported by strong regulation and supervision, sound accounting and disclosure regimes, and an effective legal system.
- When dealing with troubled banks, neither a purely “rules-based” or “discretionary” prompt corrective action approach is recommended. Instead, a balance needs to be struck between these approaches. An effective method adopted in many economies is to use a sliding scale intervention framework where the use of rules and discretion, the form of intervention and its timeliness is proportionate to the severity of the problems encountered by a troubled bank.
- The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined and transparent trigger mechanisms by safety net participants with the operational independence and legal authority to act.

- Because a bank's financial performance and capital position can deteriorate quickly, trigger mechanisms based on single measures such as capital insolvency or illiquidity may not be sufficient. Effective trigger mechanism for prompt corrective action should include a variety of relevant indicators.